## D. Tax Treaties

### 1. In general

The United States has entered into many tax treaties with other countries. These include income tax treaties, as well as estate, inheritance, and gift tax treaties. The traditional objectives of these tax treaties are to reduce or eliminate double taxation (e.g., income, estate, inheritance, or gift taxes), and to prevent avoidance or evasion of the taxes of the two countries. In the case of income tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In addition, treaties generally prevent the source country from taxing capital gains derived by a resident of the other country and other income not specifically mentioned in the treaty.

Estate and gift treaties generally cover issues such as determining whether an individual is a domiciliary of each of the signatory countries, what property may be included in the gross estate of the country that is not the decedent's country of domicile or citizenship (i.e., a country that is not the individual's primary taxing jurisdiction), the exemptions, deductions, and credits that may be granted by a country that is not the decedent's country of domicile or citizenship, and any available credits.

To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives. Treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

### 2. Saving clauses

U.S. tax treaties typically provide rules to specify the residence or domicile of an individual who may be subject to tax as a resident under the domestic laws of both countries. The United States typically includes in its tax treaties a "saving clause" in order to preserve its right to tax U.S. citizens or residents who are residents of treaty partners. By reason of this saving clause, unless otherwise provided in the treaty, the United States may continue to tax its citizens or residents as if the treaty was not in force. The scope of the saving clause, however, differs by treaty. Some saving clause provisions apply only to preserve U.S. taxing jurisdiction with respect to U.S. citizens or residents. Other saving clause provisions apply to U.S. citizens or residents and to former citizens, but not to former long-term residents. The broadest saving clause provisions apply to U.S. citizens or residents as well as both former citizens and former long-term residents.

**Income tax treaties**

There are currently 55 U.S. income tax treaties in force. Of these treaties, eight contain a provision under which the saving clause (and, therefore, the U.S. jurisdiction to tax) applies to a former citizen or former long-term resident whose loss of citizenship or resident status had as one of its principal purposes the avoidance of tax; such application is limited to the 10-year period following the loss of citizenship or resident status.[448] This approach is consistent with the alternative tax regime for former citizens and former long-term residents as described above.

Not all U.S. tax treaties in force, however, are fully consistent with the approach under the alternative tax regime. In this regard, there are 16 U.S. income tax treaties currently in force that do not permit the United States to tax its former citizens or former long-term residents under the applicable saving clause.[449] These treaties potentially conflict with the alternative tax regime with respect to both former citizens and former long-term residents.

In addition, there are 24 U.S. income tax treaties currently in force that contain saving clauses that permit the United States to tax its former citizens (for the 10 years following the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax), but do not expressly mention former long-term residents.[450] Of these treaties, 21 potentially conflict with the alternative tax regime with respect to former long-term residents.[451] According to the Department of Treasury, an additional potential conflict exists with the U.S.-Netherlands income tax treaty, because that treaty provides that the saving clause does not apply to former U.S. citizens who are nationals of the Netherlands.

There are seven U.S. income tax treaties currently in force that contain saving clauses that permit the United States to tax its former citizens, regardless of the reason for the loss of citizenship, but do not expressly mention former long-term residents.[452] According to the

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448 *See* Table 4 at A-6. The Senate also has given its advice and consent to ratification of a new U.S. income tax treaty with Italy that contains a similar saving clause provision. The treaty and protocol are awaiting ratification by the Italian government.

449 *See* Table 1 at A-3.

450 *See* Table 2 at A-4.

451 The U.S. income tax treaties currently in force with Austria, Ireland, and Luxembourg contain a saving clause provision that applies to former citizens (for the 10 years following the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax), but does not expressly mention former long-term residents. According to the Department of Treasury, because these three income tax treaties entered into force after the date of enactment of the 1996 amendments to the alternative tax regime, the 1996 alternative tax regime does not override these three treaties with respect to former long-term residents. *See* S. Rep. No. 105-8 (1997), Exec. Rep. No. 105-7; S. Rep. No. 105-8 (1997), Exec. Rep. 105-13.

452 *See* Table 3 at A-5.

Department of Treasury, five of these treaties potentially conflict with the alternative tax regime with respect to former long-term residents.[453]

Thus, of the 55 U.S. income tax treaties in force, only eight are fully consistent with the alternative tax regime. The majority of the remaining income tax treaties potentially conflict with the present-law alternative tax regime -- either with respect to former citizens (which is the case in 16 U.S. income tax treaties), or with respect to former long-term residents (which is the case in 42 U.S. income tax treaties).[454]

**Estate and gift tax treaties**

There currently are 16 U.S. estate and gift tax treaties in force. Of these treaties, only one is fully consistent with the alternative tax regime.[455] Of these treaties, 12 do not expressly permit the United States to tax estates of, or gifts by, former citizens and former long-term residents.[456] These 12 treaties potentially conflict with the alternative tax regime with respect to both former citizens and former long-term residents.

In addition, three of the 16 estate and gift tax treaties contain a saving clause that expressly permits the United States to tax estates of, and gifts by, former citizens whose loss of citizenship was tax-motivated, but do not expressly mention former long-term residents.[457] These three treaties potentially conflict with the alternative tax regime with respect to former long-term residents.

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[453] According to the Department of Treasury, because the income tax treaty with Switzerland entered into force after the date of enactment of the 1996 amendments to the alternative tax regime, even though the treaty is inconsistent with the alternative tax regime with respect to former long-term residents, the alternative tax regime does not override the treaty. *See* S. Rep. No. 105-8 (1997), Exec. Rep. 105-10. For the same reason, the U.S.-Ukraine income tax treaty should not be overridden by the 1996 alternative tax regime.

[454] As described above in notes 451 and 453, according to the Department of Treasury, five U.S. income treaties do not conflict with the 1996 alternative tax regime with respect to former long-term residents because those treaties entered into force after the date of enactment of the 1996 amendments to the alternative tax regime (*i.e.,* the income tax treaties with Austria, Ireland, Luxembourg, Switzerland, and Ukraine).

[455] *See* Table 7 at A-9. The new U.S. estate tax protocol with Germany permits the United States to tax estates of, and gifts by, former citizens and former long-term residents whose loss of such status has as one of its principal purposes the avoidance of U.S. tax for 10 years following such loss of status. Thus, the protocol amends the treaty to conform to the present-law alternative tax regime.

[456] *See* Table 5 at A-7.

[457] *See* Table 6 at A-8.

### 3. Interaction of the alternative tax regime with tax treaties

Potential conflicts between the alternative tax regime and the saving clauses in U.S. tax treaties may occur if, for example, income or gains are derived by a former U.S. citizen or former long-term U.S. resident who resides in a country with which the United States has a tax treaty. If the saving clause (and therefore the U.S. jurisdiction to tax) does not apply to the former U.S. citizen or former long-term U.S. resident, such individual generally would benefit from the treaty as if the alternative tax regime did not exist. For example, such individuals would obtain the typical treaty benefits providing for reduced rates or exemptions from U.S. tax on U.S.-source passive income, and exemptions from U.S. tax on U.S.-source capital gains, certain U.S.-source business and services income, or other U.S.-source income not specifically mentioned in the treaty. This result would apply even though U.S. tax would otherwise be imposed under the alternative tax regime with respect to these items of income during the 10-year period after citizenship relinquishment or residency termination.

The legislative history of the 1996 changes to the alternative tax regime addressed the interaction of the alternative tax regime and tax treaties. The legislative history stated that the alternative tax regime generally is consistent with the underlying principles of tax treaties. However, the legislative history contemplated that treaty provisions might conflict with the alternative tax regime. In particular, the legislative history stated that:

> [t]he Department of Treasury is expected to review all outstanding treaties to determine whether the expatriation tax provisions, as revised, potentially conflict with treaty provisions and to eliminate any such potential conflicts through renegotiation of the affected treaties as necessary. Beginning on the tenth anniversary of the enactment of the [1996 amendments to the expatriation tax provisions], any conflicting treaty provisions that remain in force would take precedence over the expatriation tax provisions as revised.[458]

Thus, until August 21, 2006 (the tenth anniversary of the enactment of the 1996 amendments to the alternative tax regime), the alternative tax regime will apply regardless of any conflicting treaty provisions that might otherwise restrict the United States' ability to tax its former citizens or former long-term residents. This may be viewed as a temporary (10-year) override of applicable treaties.

The Department of Treasury has undertaken efforts as part of its renegotiation of treaties to resolve some of these potential conflicts. The Department of Treasury has included a saving clause provision in its 1996 U.S. model income tax treaty that allows the United States to tax for 10 years (as if the treaty did not come into effect) former citizens and former long-term residents whose loss of such citizenship or resident status had as one of its principal purposes the avoidance of tax. However, as described above, conflicts in several U.S. treaties remain. The Department of Treasury has stated the following problems in attempting to resolve these remaining conflicts:

[458] H.R. Conf. Rep. No. 104-736, at 329 (1996).

While the Treasury Department intends to advocate this expanded saving clause whenever it takes part in treaty negotiations, it would be extremely difficult to renegotiate all potentially conflicting treaties within the 10-year period referred to in the legislative history of the 1996 expatriation legislation. The renegotiation of a tax treaty requires a significant commitment of resources by both countries. Accordingly, the Treasury Department must prioritize its treaty negotiations according to a variety of factors, including the relative significance of the issues to be addressed with its various treaty partners and potential treaty partners. The potential conflict between an existing treaty and the 1996 expatriation tax legislation is one such issue.

Even if the Treasury Department sought to renegotiate a treaty to eliminate this potential conflict, numerous factors may limit its ability to do so.[459] For example, a country with which the United States has a tax treaty is likely to view an agreement to expand the saving clause as a concession by that country, because the provision would expand the United States' ability to impose tax on a resident of that country. That country, if it were willing to agree to the expansion, would probably expect a concession from the United States in return. This is particularly likely because the issue would arise as a result of a treaty override by the United States.[460] The concession expected from the United States may or may not be acceptable to the United States. In addition, the Conference Report to the 1996 legislation, which purports to withdraw the treaty override after 10 years following enactment of the legislation, could provide an incentive for treaty partners to delay negotiations on the issue until the override purportedly expires in 2006. Accordingly, even if the Treasury Department had the resources to renegotiate all of the income tax treaties that conflict or (potentially conflict) with the 1996 legislation, it is not certain that mutually acceptable agreements could be reached. [461]

To the extent that conflicting treaty provisions can be fully conformed with the alternative tax regime prior to August 21, 2006, the United States can preserve its taxing jurisdiction with respect to former citizens and former long-term residents who reside in such treaty jurisdictions. However, as described above, there may be significant practical difficulties in reaching that goal. To the extent that a conflicting treaty provision cannot be conformed

[459] The difficulties involved in the renegotiation of U.S. treaties as a result of the 1996 legislation's treaty override were discussed in detail in the Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Finance, United States Senate, dated July 11, 1995.

[460] In this regard, the United States is widely perceived as overriding its treaty obligations more frequently than its treaty partners, a perception that has the potential to make it more difficult to obtain concessions from treaty partners and potential treaty partners.

[461] *See* A-20 (April 7, 2000, letter from the Department of Treasury). The Department of Treasury stated similar concerns with respect to the renegotiation of estate and gift tax treaties.

before the temporary treaty override expires in 2006, the alternative tax regime could have limited or no effect (depending on the current treaty provision) with respect to individuals who reside (or choose to reside) in that treaty jurisdiction.[462]

[462] It is unknown how many former citizens or former long-term residents currently are residents of treaty countries that have treaty provisions that conflict with the alternative tax regime.